



March 12, 2004

Ms. Jennifer J. Johnson  
Secretary  
Board of Governors of the Federal Reserve System  
20<sup>th</sup> Street and Constitution Avenue, N.W.  
Washington, D.C. 20551

Docket No. R-1176

Re: Availability of Funds and Collection of Checks  
69 FR 1470 (January 8, 2004)

Dear Ms. Johnson:

America's Community Bankers ("ACB")<sup>1</sup> is pleased to comment on the proposed rule<sup>2</sup> to implement the Check Clearing For the 21<sup>st</sup> Century Act ("Check 21" or the "Act")<sup>3</sup> issued by the Board of Governors of the Federal Reserve System (the "Federal Reserve" or the "Board"). Check 21 is designed to improve the efficiency of the nation's payment system by allowing financial institutions to create substitute checks during the check clearing process.<sup>4</sup>

The proposal would amend Regulation CC to incorporate the requirements of Check 21. Specifically, the rule would set forth 1) substitute check requirements, 2) reconverting bank duties, 3) warranties and indemnities associated with substitute checks, 4) expedited recredit procedures, and 5) model consumer awareness disclosures and other notices regarding substitute checks. In addition, the Board has requested comment on various related issues, including potential changes to Regulation CC that address concerns about fraudulent remotely created demand drafts.

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<sup>1</sup> America's Community Bankers represents the nation's community banks. ACB members, whose aggregate assets total more than \$1 trillion, pursue progressive, entrepreneurial and service-oriented strategies in providing financial services to benefit their customers and communities.

<sup>2</sup> 69 Fed. Reg. 1470 (January 8, 2004).

<sup>3</sup> Pub. L. 108-100, 117 Stat. 1177 (October 28, 2003).

<sup>4</sup> The terms financial institution and bank as used in this letter refer to insured depository institutions, including savings banks, savings associations, commercial banks, and credit unions.

## **ACB Position**

ACB supports efforts to increase the efficiency of the nation's payments system while minimizing the effect of unexpected disruptions to air and ground transportation systems. We generally support the Federal Reserve's proposed regulations and commentary that would implement Check 21. We have a number of suggestions that would further facilitate check truncation, reduce regulatory burden, and minimize consumer confusion. We specifically recommend that the Federal Reserve:

- Shorten the model consumer education disclosures;
- Allow financial institutions to provide consumer education disclosures when a customer receives a substitute check after requesting a copy of an original;
- Provide a safe harbor for financial institutions that use the Federal Reserve's model language when an account is recredited, when an expedited recredit claim is denied, or when a recredit claim is reversed;
- Institute a public awareness campaign about substitute checks;
- Clarify that ACH payments are outside the scope of Check 21's duplicate payment warranty;
- Delete proposed section 229.51(c) (the purported substitute check provision) from the final rule and clarify that items that are subject to the warranty, indemnification, and expedited recredit provisions qualify for legal equivalence;
- Clarify that even if the MICR line on the substitute check does not accurately represent the MICR line on the original check, the substitute check will still qualify as the legal equivalent of the original check, provided that the reconverting bank places a MICR line on the substitute check in MICR ink;
- Allow, but not require, collecting and paying banks to repair any portion of the MICR line on a substitute check without compromising the item's legal equivalence;
- Permit paying banks to provide substitute checks that are not printed in MICR ink to their customers, provided that all of the other requirements for substitute checks have been met;
- Amend Regulation CC to create a new warranty pertaining to remotely created demand drafts;
- Delete section 229.54(a)(2) of the proposed commentary that would permit a consumer to make an expedited recredit claim for a breach of a UCC warranty; and
- Delete the portion of the proposed commentary to section 229.54(a)(2) that would provide consumers with a right to an expedited recredit if an institution breaches a UCC warranty with respect to a proposed check; and

- Include an exclusive list of generally applicable industry standards in the commentary to the final rule.

### **Customer Education Disclosures**

Section 12 of the Act requires financial institutions to provide consumer awareness disclosures that explain substitute checks and the rights of consumers who receive substitute checks. The Federal Reserve has proposed model language to help financial institutions comply with this requirement. Financial institutions are not required to use the model language; however, those that do will be protected under the Act's safe harbor, provided that the information in the disclosure accurately describes the financial institution's policies and practices.

Model Consumer Education Disclosures. We believe that the Federal Reserve has succeeded in creating a model notice that is clear and easily understood. However, it is too long. We believe it is important to craft the most concise document possible even though financial institutions are permitted to rearrange or delete elements of the model language that are not required by statute. The Act's consumer awareness provisions are designed to help consumers understand how they will be affected by changes in check processing. To accomplish this goal, the model notice should be as brief as possible to minimize the likelihood that it will be tossed aside as one more piece of unnecessary paper. The importance of developing a concise model disclosure is further underscored by the fact that most community banks will elect to use the model language in order to take advantage of the Act's safe harbor.

The model disclosure could be streamlined by making the expedited recredit explanation less specific. Check 21 does not require consumer education disclosures to discuss the detailed rules governing expedited recredit. Instead, it requires a "brief notice" that explains legal equivalence and consumer rights. We request the Federal Reserve to generalize the expedited recredit sections of the model disclosure to only include the following points:

- Customers incurring a loss associated with a substitute check should contact the financial institution.
- Federal law provides customers with a right to an expedited recredit (up to \$2,500 within 10 days and the remainder no later than 45 days) if a customer incurs a loss due to the receipt of a substitute check instead of an original check.
- A financial institution may reverse a recredit after it investigates a claim and determines that the substitute check was properly charged to the customer's account.

If the Federal Reserve does not streamline the expedited recredit explanation, we suggest adding the phrase “mailed or delivered” to the disclosure section labeled “How to Make a Claim for an Expedited Refund.” With this revision, sentence (1) would match the verbiage in proposed section 229.54(b)(1) and would read “the date that we mailed or delivered the account statement showing the charge that you are disputing.”

Delivery of Disclosures. Check 21 requires financial institutions to provide substitute check disclosures to consumers that request a copy of a check and instead receive a substitute check.<sup>5</sup> The Act requires financial institutions to provide the disclosure at the time the request is made; however, the Federal Reserve has proposed two alternative rules governing when these disclosures must be provided and requests comment on which alternative is preferable. Alternative 1 would require a financial institution to provide the disclosure at the time of the request. Alternative 2 would require the disclosure to be made at the time the financial institution provides the substitute check to the customer.

ACB strongly urges the Board to adopt Alternative 2 because providing the mandatory disclosures at the time of the request is not realistic in the context of the day to day operations of a community bank. We also recommend that the Board interpret the phrase “at the time of the request” to allow financial institutions to provide the notice at any time after the request, up to and including the time the substitute check is delivered to the consumer.

We believe that this would be the most practical approach for a number of reasons. First, a financial institution may not know at the time of the request whether it will provide a copy of the original check or a substitute check. Consequently, requiring disclosures at the time of the request may result in the consumer receiving a disclosure describing rights that may not apply to the item that the customer ultimately receives. Second, allowing financial institutions to provide the disclosure when the substitute check is provided will enable financial institutions to more carefully monitor compliance. A wide range of bank employees, including tellers, customer service representatives, receptionists, operators, or even branch managers may take a customer’s request for a copy of a check. Ensuring that all of these individuals provide the requisite disclosure at the time the request is made would be a significant compliance and training challenge. Alternative 2 minimizes this problem by enabling financial institutions to limit the number of personnel tasked with compliance. Finally, this approach would avoid the possibility of two separate mailings in the event that a check is requested via telephone.

Safe Harbor for Disclosures. In addition to distributing customer education disclosures about substitute checks, financial institutions are also required to notify customers when:

- Their account has been recredited;
- An expedited recredit claim has been denied; and
- An amount previously recredited has been reversed.

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<sup>5</sup> 12 U.S.C. §5011(b)(4).

The proposed rule includes clear and concise model notices that are designed to help financial institutions satisfy these disclosure requirements and clarify regulatory expectations. To make the model notices even more useful, we suggest that the Federal Reserve create a safe harbor whereby financial institutions using the model language will be deemed to be in compliance with the notice requirements, provided they are given in a timely manner.

Public Awareness Campaign. Community banks will strive to make the transition to substitute checks as smooth as possible for their customers and will work to explain how customers are affected by changes in the check processing system. To augment these efforts, ACB strongly urges the Federal Reserve to institute a public awareness campaign similar to the one used to introduce the new \$20 note. Not only should the Federal Reserve target the general public, education efforts should be extended to include local law enforcement agencies. We are concerned that prosecutors and law enforcement officials will be reluctant to accept a substitute check's legal equivalence, particularly when prosecuting fraud cases.

### **ACH Payments and the Duplicate Payment Warranty**

ACB strongly urges the Federal Reserve specifically to clarify in the language of the final regulation that Automated Clearing House ("ACH") debits are outside the scope of the Check 21 warranty. Specifically, we ask the Board to clarify that a reconverting bank that has presented a substitute check to a paying bank would not be in breach of the duplicate payment warranty in the event that an electronic funds transfer, such as an ACH debit, is subsequently initiated using information obtained from an original check or a substitute check.

Under Check 21, a financial institution that transfers, presents or returns a substitute check warrants that the substitute check is not a duplicate of a check that already has been paid. The Act states that "no depository bank, drawee, drawer, or endorser will receive presentment or return of the substitute check, the original check, or a copy or other paper or electronic version of the substitute check" such that such person "will be asked to make a payment *based on a check* that the bank has already paid"<sup>6</sup> [emphasis added].

We are concerned that this language could be read to consider an ACH entry as "an electronic version" of a substitute check or an original check to which the duplicative payment warranty would apply. This type of situation could occur when Bank A creates a substitute check and presents it to Paying Bank. Paying Bank settles for the substitute check. Subsequently, a person transfers the same or a duplicate of the substitute check to a merchant who uses the check as a source document to create an ACH debit entry that results in duplicate funds being collected from the Paying Bank.

We do not believe that ACH payments should be construed as a "payment based on a check" for purposes of the Check 21 duplicate payment warranty. An ACH debit is

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<sup>6</sup> 12 U.S.C. §5004.

processed through the ACH network and is subject to the ACH rules and consumer protections applicable to electronic funds transfers under Regulation E. Further, Section 205.3(b) of the Official Staff Commentary to Regulation E provides that where a consumer authorizes the use of a check for initiating an electronic funds transfer, the transaction is not deemed to be originated by a check.

Similarly, an ACH debit transaction initiated with a check is not an “electronic version of the substitute check or original check” because the ACH debit represents a new payment transaction and is not a continuation of a check transaction. ACH conversion programs use the paper check as a source document to initiate an automated clearinghouse electronic payment to complete a payment from a consumer to a merchant. The information needed to initiate an ACH transaction is obtained from the check, so the source document does not flow through the payment processing and settlement stream. In some cases, such as point of purchase transactions, an original check is returned to the consumer. In other cases, the original check or an image of the check is retained by the merchant is subject to various recordkeeping requirements.<sup>7</sup>

### **MICR Line Concerns**

We believe that portions of the proposed rule governing a substitute check’s MICR line will create uncertainty as to how substitute checks should be handled. As a general matter, we believe that financial institutions should be encouraged to treat substitute checks just like original paper checks.

Check 21 was not intended to change item processing operations; substitute checks were designed to be processed just like paper checks. Today, all financial institutions in the payment stream may make MICR line corrections as necessary. We strongly urge the Board to interpret the Act to permit financial institutions to correct substitute check MICR lines in the same manner as paper checks are corrected today. Any other interpretation will inhibit the utility of substitute checks and will hinder the payments system.

Legal Equivalence and Purported Substitute Checks. To meet the statutory requirements for a substitute check, a financial institution must print all of the MICR information from the original check on a substitute check that it creates, regardless of whether the MICR line on the original was properly encoded by a prior bank. If the MICR lines do not match, the item will not be the legal equivalent of the original check and the reconverting bank will have breached one of the substitute check warranties. Under the proposed rule, a substitute check that does not meet the MICR line requirement will not qualify for legal equivalence, but it will be subject to the Act’s warranty, indemnity, and expedited recredit provisions. This is known as the purported substitute check provision.

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<sup>7</sup> See e.g. National Automated Clearing House Association Operating Rules. Article 2, Section 2.9, subsection 2.9.3.2 (2003).

We believe that this approach will have unintended consequences. If an item does not meet the definition of a substitute check, we do not believe that it can be subject to the substitute check warranties.

We are concerned that the proposed approach would create an unworkable result. Specifically, the proposal would preclude a reconverting bank from correcting a MICR read error on an original check. Further, if a reconverting bank creates a substitute check that does not mirror the MICR line of the original check, collecting and paying banks down the payment stream may not know that they have received an item that is not legally equivalent to the original check. If the collecting or paying bank does recognize that the item contains a MICR error, it would, as a practical matter, have to return that substitute check to the reconverting bank because the paying bank would have no authority to charge its customer's account.

For parties down the collection chain, the status of a substitute check as the legal equivalent of the original check should not be dependent on whether the MICR line is properly read from the original check. Further, reconverting banks should not be discouraged from correcting MICR errors on the original check.

We strongly urge the Federal Reserve to clarify that even if the MICR line on the substitute check does not accurately represent the MICR line on the original check, the substitute check will still qualify as the legal equivalent of the original check, provided that the reconverting bank places a MICR line on the substitute check in MICR ink. Under this approach, the amount field, the routing and transit fields, or any other fields could vary from the original check. The Act's warranty and indemnification provisions would protect any banks or consumers that receive a substitute check with incorrect MICR information.

This interpretation would allow financial institutions to treat substitute checks like paper checks. Reconverting banks would not be precluded from correcting MICR read errors on original checks, nor would collecting or paying banks further along in the collection process have doubts about the status of substitute checks that they receive.

We also urge the Federal Reserve to 1) delete the purported substitute check provision from the final rule and 2) clarify that items that are subject to the warranty, indemnification, and expedited recredit provisions qualify for legal equivalence. Alternatively, if a purported substitute check does not receive the benefit of legal equivalence, it should not be subject to the Act's warranty, indemnification, and expedited recredit provisions.

Repair of Substitute Check by Collecting/Paying Bank. The proposed rule would allow collecting and paying banks to repair a substitute check that was created from an original check that contained an error in the amount field. The proposal does not discuss other situations in which a paying or collecting bank may repair the MICR line of a substitute check.

As a general matter, we believe that any rules governing the repair of substitute checks should encourage financial institutions to treat substitute checks in the same manner as original paper checks. Accordingly, ACB strongly urges the Federal Reserve to allow, but not require, collecting and paying banks to repair any portion of the MICR line on a substitute check without compromising the item's legal equivalence. This approach would allow collecting and paying banks to repair MICR on substitute checks under the same rules that govern the repair of paper checks.

Prohibiting collecting and paying banks from engaging in MICR repair would not be consistent with the Act's goal of facilitating check truncation. Instead, it would dramatically slow check processing.

Substitute Checks Without MICR Ink. We also request that the Federal Reserve allow paying banks to provide their customers with substitute checks that are not printed in MICR ink, provided that all of the other requirements for substitute checks have been met. There is no need to print in MICR ink substitute checks that have been paid and cancelled. These items will not be used for forward collection or return, nor will consumers be able to know whether a check is encoded in MICR ink. It is less expensive to print a non-MICR substitute check, and we do not believe that paying banks should be required to incur the cost of using MICR ink to create this class of substitute checks.

### **Remotely Created Demand Draft Warranty**

As part of the Check 21 rulemaking, the Federal Reserve requests comment on whether Regulation CC should be amended to change the allocation of liability for a remotely created demand draft that is disputed by a customer.<sup>8</sup>

ACB strongly supports revising Regulation CC to create a new warranty pertaining to remotely created demand drafts. This approach would reallocate fraud loss from the paying bank to the presenting bank by allowing the paying bank to use a warranty claim to absolve itself from honoring an unauthorized item. Such a provision would allow the bank of first deposit to charge the account of a merchant or vendor that initiated the allegedly unauthorized draft. The merchant could then deal directly with the consumer for resolving any payment for goods or services.

A remotely created demand draft is created when a consumer agrees to pay for goods and services by allowing a vendor to prepare a pre-authorized check drawn on the customer's bank account. The consumer provides the necessary account and bank information and the vendor generates a check with "Debit of Account Authorized By Customer" or similar language printed in the signature line. While this payment method is convenient for consumers who do not want to be troubled with ensuring that bills such as monthly

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<sup>8</sup> 69 Fed. Reg. 1482.



health club dues or utility payments have been made, the number of unauthorized remotely-created demand drafts has become a significant problem.<sup>9</sup>

Due to the level of fraud associated with remotely created demand drafts, the National Conference of Commissioners on Uniform State Laws and the American Law Institute approved revisions to Articles 3 and 4 of the Uniform Commercial Code regarding remotely created consumer items. Under the revised UCC, a person who transfers a remotely created consumer item warrants that “the person on whose account the item is drawn authorized the issuance of the item in the amount for which the item is drawn.”

This approach treats unauthorized drafts like items bearing a forged endorsement. As a result, the drawee bank may shift the loss to the bank of first deposit, which can charge the disputed item back against the account of its customer.

ACB strongly supports incorporating a remotely created demand draft warranty into Regulation CC. However, we urge the Federal Reserve to go beyond the UCC amendments and apply the warranty to all remotely created items, not just those drawn on a consumer account. We believe that all accounts, including businesses and non-profit organizations, should be covered.

### **Breach of UCC Warranties**

The proposed commentary to section 229.54(a)(2) of the proposal improperly expands the application of Check 21’s expedited recredit provisions by providing consumers with a right to an expedited recredit if an institution breaches UCC warranties with respect to a substitute check. Check 21 states that a consumer’s expedited recredit claim must allege, among other things, that the consumer has “a warranty claim with respect to [a] substitute check.”<sup>10</sup>

We believe that this warranty claim should be limited to the substitute check warranties identified in the statute.<sup>11</sup> Accordingly, we request the Federal Reserve to delete the proposed commentary that would permit a consumer to make an expedited recredit claim for a breach of a UCC warranty.

Allowing consumers to claim expedited recredit for breach of UCC warranties on a substitute check would unnecessarily expand the scope of Check 21. The statute’s warranty structure and expedited recredit provisions are intended to protect customers against losses stemming from the fact that a consumer received a substitute check instead

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<sup>9</sup> In most states, banks agreeing to recredit a customer’s account for losses associated with unauthorized drafts cannot look to the depository bank for indemnification. This is because these unauthorized debits are treated like checks with forged signatures. Under the commercial code of most states, a paying bank that pays a check cannot shift that loss to the depositing bank for a check that it later determines was forged. UCC § 3-418.

<sup>10</sup> 12 U.S.C. § 5006(a)(1)(B)(ii).

<sup>11</sup> Under Section 5 of Check 21, a depository institution that transfers, presents or returns a substitute check warrants that the substitute check 1) meets the requirements for legal equivalence and 2) is not a duplicate of a check that already has been paid.

of an original check. Hence, there is no reason to add different and new consumer protections for warranties that are breached under other law just because the customer receives a substitute check. Consumers that receive a substitute check will continue to have all of the rights and protections provided under Regulation CC and the UCC to the same extent as if the customer had been provided the original check.<sup>12</sup> Allowing consumers to bring a claim for expedited recredit based on a warranty arising under other check law would unnecessarily confuse the dispute resolution process.

### **Generally Applicable Industry Standards**

We believe that the commentary to the proposed rule should include an exclusive list of generally applicable standards. This approach will provide certainty to the financial services industry when the Act becomes effective and will enable the Federal Reserve to propose changes to this list as the payments system evolves.

At various points, Check 21 refers to “generally applicable industry standards.” The Federal Reserve proposes to include only a general reference to generally applicable industry standards in the rule text. If only one industry standard applies, the commentary should identify that standard.

We are concerned that the proposed rule would allow any number of banks, vendors, associations, or other organizations to create a hodgepodge of new “standards” that claim to be Check 21 compliant. Unless the Federal Reserve establishes an exclusive list of generally applicable industry standards, there likely will be many questions within the industry as to whether a particular standard is a generally applicable industry standard for purposes of Check 21.

### **Conclusion**

We appreciate the opportunity to comment on this very important proposal. ACB supports the Federal Reserve in its efforts to craft a workable implementing regulation for Check 21. We stand ready to work with Federal Reserve staff to develop a regulation that will allow the industry to take advantage of the efficiencies contemplated in the statute.

In summary, we would like to reiterate our view that substitute checks should be treated in the same manner as paper checks. Imposing special substitute check MICR line and requirements would make check processing less efficient and would not carry out the

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<sup>12</sup> For example, a financial institution is liable to its customer under the UCC for charging its customer’s account for a check that is not “properly payable.” This liability can exceed the amount of the improper charge to the customer’s account, as a financial institution that improperly debits a customer’s account is liable under the UCC to the customer not only for the amount of the improper debit, but also for the amount of any damages that are proximately caused by any wrongful dishonors resulting from the improper debit.

Act's purpose of facilitating check truncation. Likewise, the regulations implementing Check 21 should not encompass ACH transactions or breaches of the UCC warranties.

We congratulate the Federal Reserve on developing a set of model notices and disclosures that are easy to read and understand. To maximize the utility of the model language, we encourage the Federal Reserve to make the consumer education disclosure as concise as possible. We also ask the Board to give particular consideration to allowing financial institutions to provide these consumer education disclosures after a customer requests a copy of a check and receives a substitute check instead.

In conclusion, we respectfully request the Federal Reserve to:

- Shorten the model consumer education disclosures;
- Allow financial institutions to provide consumer education disclosures when a customer receives a substitute check after requesting a copy of an original;
- Provide a safe harbor for financial institutions that use the Federal Reserve's model language when an account is recredited, when an expedited recredit claim is denied, or when a recredit claim is reversed;
- Institute a public awareness campaign about substitute checks;
- Clarify that ACH payments are outside the scope of Check 21's duplicate payment warranty;
- Delete section 229.51(c) (the purported substitute check provision) from the final rule and clarify that items that are subject to the warranty, indemnification, and expedited recredit provisions qualify for legal equivalence;
- Clarify that even if the MICR line on the substitute check does not accurately represent the MICR line on the original check, the substitute check will still qualify as the legal equivalent of the original check, provided that the reconverting bank places a MICR line on the substitute check in MICR ink;
- Allow, but not require, collecting and paying banks to repair any portion of the MICR line on a substitute check without compromising the item's legal equivalence;
- Permit paying banks to provide substitute checks that are not printed in MICR ink to their customers, provided that all of the other requirements for substitute checks have been met;
- Amend Regulation CC to create a new warranty pertaining to remotely created demand drafts;
- Delete section 229.54(a)(2) of the proposed commentary that would permit a consumer to make an expedited recredit claim for a breach of a UCC warranty; and

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- Delete the portion of the proposed commentary to section 229.54(a)(2) that would provide consumers with a right to an expedited recredit if an institution breaches a UCC warranty with respect to a proposed check; and
- Include an exclusive list of generally applicable industry standards in the commentary to the final rule.

Please contact Krista Shonk at 202-857-3187 or via email at [kshonk@acbankers.org](mailto:kshonk@acbankers.org) or Rob Drozdowski at 202-857-3148 or via email at [rdrozdowski@acbankers.org](mailto:rdrozdowski@acbankers.org) should you have any questions.

Sincerely,

A handwritten signature in black ink that reads "Charlotte M. Bahin". The signature is written in a cursive, flowing style.

Charlotte M. Bahin  
Senior Vice President  
Regulatory Affairs